Vol 311

No. 360

Office - Supreme Court, U. S.
FILED
AUG 22 1940
CHARLES ELMORE CROPLEY
CLERK

Supreme Court of the United States

OCTOBER TERM, 1940.

LONG ISLAND DRUG COMPANY, INC.,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION AND BRIEF FOR WRIT OF CERTIORARI.

OTHO S. BOWLING,
Counsel for Petitioner.

INDEX

PETITION: PAGE

Two Cases on a Single Record 1

History of the Case 2

Jurisdiction 2

Questions Relied On 3

BRIEF:

Statement of Case 7

Official Reports Below 7

Grounds on Which Jurisdiction Is Invoked 8

Material Facts 8

Summary of Argument 11

POINT I—The presumption that the Commissioner is correct is purely procedural and the Third and Sixth Circuits have so held 11

Decisions of Other Circuits 13
Decision of This Court 13

POINT II—Proof that the salaries of business executives were fixed in due course creates a presumption that they are reasonable, requiring some proof to overcome it 14

Circuit Court of Appeals for the Third Circuit 14

Circuit Court of Appeals for the Fourth Circuit 15

POINT III—Why the decision below is in irreconcilable conflict with the decisions of the other circuits 16

AUTHORITIES

PAGE

Long Island Drug Company, Inc. v. Commissioner of Internal Revenue, 35 B. T. A. 328 7

Long Island Drug Company, Inc. v. Commissioner of Internal Revenue, 111 Fed. (2d) 593 7

Lunsford v. Commissioner of Internal Revenue, 62 Fed. (2d) 740 ..... 4, 13

Manchester Board & Paper Co., Inc. v. Commissioner of Internal Revenue, 89 Fed. (2d) 315 ..... 4, 13

Ox Fibre Brush Co. v. Blair, 32 Fed. (2d) 42 ..... 3, 15

United States v. Philadelphia Knitting Mills, 273 Fed. 657 15

United States v. Seminole Nation, 290 U. S. 417 2

28 U. S. C. A., Sec. 347 2

28 U. S. C. A., Sec. 350 2

Supreme Court of the United States

OCTOBER TERM, 1940.

LONG ISLAND DRUG COMPANY, INC.,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

To the Honorable, the Chief Justice, and the Associate Justices of the Supreme Court of the United States:

This the petition of Long Island Drug Company, Inc., a domestic corporation organized under the laws of the State of New York, with its principal office at Jamaica, New York City, respectfully shows:

1. This is a petition for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Two Cases on a Single Record.

2. *There are two cases tried and determined on a single record. The cases involved Petitioner's income tax returns for the years 1931 and 1932-1933. This petition is filed in the case concerning the 1931 tax* (B. T. A. Docket No. 75225). *A companion petition is being filed in the case concerning the 1932-1933 tax* (B. T. A. Docket No. 79616).

History of the Case.

3. Petitioner filed its petitions with the Board of Tax Appeals to redetermine deficiencies assessed against it by the Commissioner of Internal Revenue for income taxes for the year 1931 (Petition 1931; R. 5-12). This, together with the petition concerning the return for the years 1932-1933 (R. 14-25), was heard at a consolidated hearing. The Board handed down decisions determining that there were deficiencies as found by the Commissioner (R. 37, 38). The opinion of the Board is reported in 35 B. T. A. 328. Thereupon Petitioner filed petitions for review by the United States Circuit Court of Appeals for the Second Circuit (Petition 1931; R. 39-42). That court affirmed the determination of the Board (R. 137). The opinion of that court is reported in 111 Fed. (2d) 593. The opinion of the Circuit Court was handed down May 6, 1940. Its order is dated May 23, 1940. On May 21, 1940, within the time allowed by the rules of that court, Petitioner filed its petition for rehearing. On May 23, 1940, said court handed down its order denying the petition (R. 135).

Jurisdiction.

4. The Supreme Court has jurisdiction because this is a petition to review a United States Circuit Court of Appeals (Act of Feb. 13, 1925, 28 USCA §347). The petition for certiorari is filed within three months after the date of the order of affirmance and within three months after the denial of the petition for a rehearing (28 USCA §350; *United States* v. *Seminole Nation,* 290 U. S. 417, 421).

The Questions Relied On.

5. The case arose because Petitioner in its income tax returns for the years in question claimed, as deductions from gross income, the salaries paid four officers. These salaries were based upon fixed amounts, plus percentages of profits. Petitioner, before the Board of Tax Appeals, offered proof that the salaries paid, including percentages of profits, were reasonable. The Commissioner offered no proof. The Board of Tax Appeals, after reviewing Petitioner's proof, rejected it as insufficient on the ground that Petitioner had

> "* * * failed to sustain the burden of proof to show that respondent's determination was erroneous" (R. bottom p. 35).

These questions then arise:

A. When the taxpayer shows that the salaries of executives were arrived at in regular course of administration of the business, coupled with proof of the volume of business done and the duties performed, does not a presumption arise that the salaries so paid were reasonable, requiring some contrary evidence before the taxpayer's proof may be disregarded? The Circuit Court of Appeals for the Fourth Circuit so held (*Ox Fibre Brush Co.* v. *Blair,* 32 Fed. [2d] 42, 45), a decision which cannot be reconciled with this decision of the Circuit Court of Appeals for the Second Circuit.

This is a question of great general importance in the administration of the revenue laws. If the Board of Tax Appeals can ignore *all* the evidence of reasonableness, as it did here; if the Collector can slash salaries as he pleases without advancing any reason therefor; if his arbitrary judgment may be substituted for that of the managers of the business whose good faith is not attacked, then the taxpayer has no real remedy for capricious administrative action.

B. Is not the presumption that the determination of the Collector of Internal Revenue was correct, so as to require the taxpayer to produce some evidence to the contrary, a mere *procedural* presumption, which disappears when evidence is produced? The Circuit Court of Appeals for the Third Circuit (*Manchester Board & Paper Co., Inc.* v. *Commissioner of Internal Revenue,* 89 Fed. [2d] 315, 317) and for the Sixth Circuit (*Lunsford* v. *Commissioner of Internal Revenue,* 62 Fed. [2d] 740, 742) have so held. The Board of Tax Appeals apparently held the contrary because it based its decision on the theory that Petitioner had "failed to sustain *the burden* of proof *to show* that *respondent's determination* was erroneous" (our italics, R. 35), that is to say, it assumed that the presumption could be put in the scales against Petitioner's proof. If it had weighed respondent's proof it would have been compelled to make a finding as to reasonableness, which it did not do. True, the Circuit Court of Appeals interpreted what the Board said as "the equivalent of a specific finding that the compensation paid, over and above the amount allowed by the Commissioner as deductible, was unreasonably high" (R. 129), but we consider this interpretation erroneous, and it is contrary to the one advanced by the Assistant Attorney General in his brief. The Circuit Court of Appeals did not expressly disapprove of the cited decisions in the Third, Fourth and Sixth Circuits, but the result reached cannot be reconciled with them.

This also is a question of great general importance, a corollary to the question first defined, because if the presumption is merely procedural, then the Board of Tax Appeals must weigh Petitioner's uncontradicted proof, and not base a decision, as it did here, on the theory that a non-existent presumption of substance outweighed it. The Supreme Court, so far as our research reveals, has never passed on this point, and it is important to the administration of the revenue laws that it should.

6. Because the Circuit Court of Appeals for the Second Circuit erred in deciding the foregoing questions, because its decisions cannot be reconciled with the cited decisions of other circuits, and because the questions are of general importance, all of which matters are more fully expounded in the brief accompanying this petition, Petitioner prays that a writ of certiorari issue to the United States Circuit Court of Appeals for the Second Circuit, to the end that its error, if such there be, may be corrected.

Dated, August 20, 1940.

Respectfully submitted,

OTHO S. BOWLING,
Counsel for Petitioner.

I certify that, in my opinion, the foregoing petition is well founded and that it is not interposed for the purpose of delay.

OTHO S. BOWLING,
Counsel for Petitioner.

Supreme Court of the United States

OCTOBER TERM, 1940.

LONG ISLAND DRUG COMPANY, INC.,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Statement of the Case.

This is a petition for a writ of certiorari to review a decision of the United States Circuit Court of Appeals for the Second Circuit, which affirmed orders of the Board of Tax Appeals determining deficiencies in Petitioner's income taxes for the years 1931, 1932 and 1933.

Official Reports of Opinions Below.

The case in the Board of Tax Appeals is reported as *Long Island Drug Co.* v. *Commissioner of Internal Revenue*, 35 B. T. A. 328.

In the Circuit Court of Appeals it is reported as *Long Island Drug Co.* v. *Commissioner of Internal Revenue*, 111 Fed. (2d) 593.

Grounds on Which Jurisdiction Is Invoked.

Jurisdiction is invoked on the grounds that the United States Circuit Court of Appeals for the Second Circuit erred in deciding important questions of general law, apparently in conflict with the decisions of other Circuit Courts of Appeals; questions not yet determined by the Supreme Court.

Material Facts.

Petitioner, Long Island Drug Company, Inc., was incorporated in 1917 (R. 28, 51) with an authorized capital of $10,000, but it began business with a paid in capital of but $3,000 (R. 51, 56). For this capital it issued thirty shares, ten each to Mr. Hyman Alkon, Mr. Maurice Alkon and Mr. Bernard H. Mindling, who were also its officers (R. 51, 52, 60, 62). Its business was the wholesale drug business. It entered into competition with old, well-established concerns (R. 56).

Within four years its net worth had apparently grown from the original $3,000 to $78,000, because in 1921 its three shareholders each sold one-half of his holdings for a total of $39,000 (R. 28, 52, 80). The shares so sold were taken in the name of Mr. Benedict Maisel, a nominee for the beneficial owners, the parents of Mr. Charles J. Steinberg (R. 28, 64, 80, 84).

By the beginning of 1931 the company had so prospered that in addition to its original capital of $3,000 it had a capital surplus of $390,753.22 (R. 56).

There was dissension among the stockholders. The three original shareholders, who were still the executive officers, were dissatisfied with the salaries they were getting. Mr. Steinberg wanted the business of the corporation enlarged—he wanted it to go into Brooklyn, which it had not covered theretofore—and he wanted it to enlarge further by developing a line of merchandise under its own trade name. This the old officers were unwilling to do. They took the position that they had enough work to do as it was (R. 58). This

disagreement led to a proceeding in the New York Courts praying for dissolution of the corporation. The petition was dismissed, but out of the proceeding grew a compromise. By this compromise the new territory was opened and the new line of merchandise offered (as the Steinberg interests had wished) and Mr. Steinberg himself was employed to do this additional work, among other things (R. 29, 58-59, 84). The compromise also included an arrangement about salaries—the arrangement under which the salaries under examination were paid.

This arrangement was embodied in a by-law of the corporation adopted March 11, 1931, which read:

> "Section 6. Compensation of Officers. The President shall receive a salary of $13,500 per annum, the Treasurer shall receive a salary of $12,500 per annum, the Secretary shall receive a salary of $12,500 per annum, and the Assistant Secretary shall receive a salary of $12,500 per annum. In addition thereto each of said officers shall receive as additional compensation an amount equal to 12½% of the net profits of the corporation. The foregoing compensations shall continue in force undiminished unless changed by unanimous consent of the Board of Directors. Net profits of the corporation for purposes of this section shall be determined by subtracting from the net profit returned to the Federal Government the amount of State and Federal taxes paid or due thereon" (Ex. 4; R. 113).

Pursuant to this by-law the salaries in question were paid. They were (30):

1931.

	Fixed	*Contingent*	*Total*
H. Alkon, President.....	$13,500	$ 8,000	$21,500
M. Alkon, Treasurer.....	12,500	8,000	20,500
B. H. Mindling, Secretary.	12,500	8,000	20,500
C. J. Steinberg, Assistant Secretary.....	12,500	8,000	20,500
Total.....	$51,000	$32,000	$83,000

1932 AND 1933.

	Fixed	*Contingent*	*Total*
H. Alkon, President.....	$13,500	$ 2,500	$16,000
M. Alkon, Treasurer.....	12,500	2,500	15,000
B. H. Mindling, Secretary.	12,500	2,500	15,000
C. J. Steinberg, Assistant Secretary.....	12,500	2,500	15,000
Total.....	$51,000	$10,000	$61,000

It will be noted that the percentages of income paid these executives for salaries bore no relationship to stockholdings. Mr. Steinberg, whose parents owned 50% of the stock, received but 12½% of the profits. The old officers, who divided the other half of the stock among themselves, received 37½% of the profits.

Petitioner deducted the taxes so paid in its income tax returns. When the 1931 return was audited the Commissioner deducted so much of the salaries as were based upon percentages of net income, saying:

> "The 'extra distribution' of $32,000 was not the result of free bargaining which clearly indicates that the payments were not compensation for the value of services rendered, but represent a distribution of profits, and are therefore, not ordinary and necessary expenses within the meaning of section 23 (a) of the Revenue Act of 1928 (Botany Worsted Mills v. United States, Cumulative Bulletin VIII-I, p. 271; Samuel Heath Company v. United States, 2 Fed. Supp. 637)" (R. 11).

A year later the returns for 1932 and 1933 were under examination, and the Commissioner, without making any fresh examination of the question, again disallowed the contingent (percentage of profit) salaries, writing:

> "The amount of officers' and attorneys' salaries allowed as a deduction is based upon a decision at a conference in the office of the internal revenue agent in charge with respect to the year 1931" (R. 22).

The taxpayer filed petitions with the Board of Tax Appeals. The petitions were heard together. Petitions for review were filed with the United States Circuit Court of Appeals for the Second Circuit. The Board was there affirmed.

Summary of Argument.

The case presents two questions of general importance:

(a) Is the presumption that the Commissioner of Internal Revenue acts correctly a mere procedural presumption, or is it a presumption of substance which may be weighed against uncontradicted proof offered by the taxpayer?

The Circuit Courts of Appeals for the Third and Sixth Circuits have held the presumption to be only procedural.

(b) Is not proof that the salaries of the executives of a corporation have been arrived at in due course *prima facie* proof that they are reasonable, requiring some proof to overcome it?

The Circuit Court of Appeals for the Fourth Circuit has so held. The decision of the Circuit Court of Appeals below cannot be reconciled with these decisions of the Third, Fourth and Sixth Circuits.

POINT I

The presumption that the Commissioner is correct is purely procedural, and the Third and Sixth Circuits have so held.

The question of fact before the Board was whether the salaries were reasonable. It made findings of other facts, evidentiary facts in considerable detail (R. 27-32). It made *no* finding of fact as to the essential point in dispute. The

learned Assistant Attorney General who wrote respondent's brief below concurred with us in this, because he wrote:

> "The Board made no findings as to whether the payment of 12½% of the net earnings of the corporation to each of the four executive officers, a total of 50% of the net earnings, was reasonable compensation for services rendered and explained its failure to do so in its opinion * * *" (p. 12, brief below).

Nevertheless, the Circuit Court of Appeals, endeavoring to sustain the Board, said:

> "The petitioner says that the Board made no finding that the compensation paid was unreasonably high. It is true that the Board made no such finding in specific terms. What the Board did do was to hold that the burden was on the petitioner to show that the amounts paid were no more than reasonable, the petitioner's evidence was too weak to carry the burden. We regard this as the equivalent of a specific finding by the Board that the compensation paid, over and above the amount allowed by the commissioner as deductible, was unreasonably high" (R. 129).

But this interpretation disregards what the Board said. It is wrong to assume that the Board used language inadvertently. What the Board said was that petitioner's proof failed

> "to sustain the *burden* of proof *to show* that *respondent's determination* was erroneous" (our italics, R. 35).

It did *not* say that Petitioner's proof (the only proof) showed or even suggested unreasonableness. So it was not inadvertent that the Board made *no* specific finding as to the one ultimate fact before it. It was deliberate. It was because the Board conceived that the presumption that the Collector was right is one of *substance,* of some *great weight,* so that *no fact* is presented to the Board for decision until the petitioner presents proof of whatever arbitrary weight standard the Board has adopted.

Decisions of Other Circuits.

The Third Circuit has held:

> "* * * the presumption that the determination of the Commissioner is right is simply procedural and cannot survive the production of evidence tending to show the determining fact * * *" (*Manchester Board & Paper Co., Inc.* v. *Commissioner of Internal Revenue,* 89 Fed. [2d] 315, 317).

The Sixth Circuit has held:

> "The presumption that the Commissioner is right is procedural * * *" (*Lunsford* v. *Commissioner of Internal Revenue,* 62 Fed. [2d] 740, 742).

Decision of This Circuit.

The Circuit Court of Appeals below did not *expressly* disagree with these decisions. What it wrote was:

> "The Board was right in holding that the burden of proving that the claimed deduction was proper was on the petitioner. *Burnet* v. *Houston,* 283 Fed. 223. The burden was not merely one of going forward with evidence, as the petitioner maintains" (R. 129).

Petitioner never contended before that court that the taxpayer does not have both the burden of proceeding with proof and the burden of preponderating, once *conflicting* proof has raised an *issue.* What Petitioner contended was (a) the presumption that the Collector is right is purely procedural; (b) Petitioner's proof that the salaries were arrived at in regular course is *prima facie* proof that they were reasonable unless something inherent in the facts suggests the contrary (which the Circuit Court of Appeals did not intimate), and, therefore, since there was no *conflicting* proof, there was *no* evidence on which to base a finding of unreasonableness. In the light of this argument the Court evidently rejected the decisions in the Third and Sixth Circuits holding that the presumption is only procedural. That was the *only* contention of Petitioner, and Petitioner's contention, the Circuit Court of Appeals said, was wrong.

POINT II

Proof that the salaries of business executives were fixed in due course creates a presumption that they are reasonable, requiring some proof to overcome it.

We concede that such contradictory proof may be inherent in the facts themselves, but the Circuit Court of Appeals did not pretend to find such proof here. It wrote:

> "It may fairly be said in the petitioner's favor that the case is not one where utterly extravagant amounts were paid to officers, in guise of compensation but without real relation to the measure of their services. *Botany Mills* v. *United States,* 278 U. S. 282. Nor is it a case where the payments bore a close relation to the stockholdings of the recipients and so might fairly be viewed as dividends for purpose of tax, despite the name given to the payments." (R. 128).

The Circuit Court of Appeals below necessarily rejected Petitioner's argument that when it is shown that salaries are fixed in due course the presumption is that they are reasonable, because it would not have affirmed otherwise. The Commissioner offered no proof. There was no inherent defect in Petitioner's proof—at least none was suggested. Therefore the proof was all one way, if it should be presumed that salaries arrived at in due course are reasonable.

Other Circuit Courts of Appeals have held that there is such a presumption, requiring proof to overcome it.

Circuit Court of Appeals for the Third Circuit.

> "* * * Whether services were rendered, and whether also they were commensurate with the salary paid, are matters of judgment and discretion, reposed by general law in the board of directors of the corporation. As the board of directors is charged with the duty and clothed with the discretion of fixing the

> salaries of the corporation's officers, the government has no right (until expressly granted by statute) to inquire into and determine whether the amounts thereof are proper, that is, whether they are too much or too little. But, while the amount of salary fixed by a board of directors is presumptively valid, it is not conclusively so, because the government may inquire whether the amount paid is salary or something else'" (*United States* v. *Philadelphia Knitting Mills*, 273 Fed. 657).

Circuit Court of Appeals for the Fourth Circuit.

> "The *prima facie* presumption in favor of the action which a corporation has taken in cases of this kind has repeatedly been recognized by the Board of Tax Appeals itself. For example, see Collins-McCarthy Land Co. v. Commissioner, 43 BTA 1280; Standard Silk Dyeing Co. v. Commissioner, 9 BTA 648. This presumption is in nowise inconsistent with the principle that the burden of proof rests upon the taxpayer" (*Ox Fibre Brush Co.* v. *Blair*, 32 Fed. [2d] 42, 45).

Here is a case where the good faith of the corporation has not been questioned. If the fact that salaries of executives were fixed by those managing a business carries no presumption of reasonableness, what remedy does the taxpayer have? There is no *standard* for *executives*. Two businesses, two organizations are seldom precisely alike. Can an examiner of the Bureau of Internal Revenue, at his mere caprice, overrule the judgment of the experienced managers of a business as to what is reasonable? Apparently he can—unless *he* has the burden of producing *some* proof to justify his decision when the taxpayer shows that the salaries were arrived at in regular course, and the surrounding circumstances create no suspicion of irregularity or unreasonableness. The Circuit Court of Appeals concluded:

> "And whatever might have been our views if we had tried the facts, we cannot say that the Board's finding was so clearly out of line with the evidence as to be arbitrary and unfair." (R. 129).

Now, unless such proof *does* require the Collector to come forward with some evidence to justify him, it means that unless the taxpayer proves reasonableness to a practical mathematical certainty (and there can never be such proof on *this* question) it is never "arbitrary" and "unfair" to disregard all the proof entirely—as was done here.

POINT III

Why the decision below is in irreconcilable conflict with the decisions of the other circuits.

We have shown that the Third and Sixth Circuits have held that the presumption that the Collector is right is purely procedural, and the Third and Fourth Circuits have held that proof that salaries were arrived at in regular course is *prima facie* proof of their reasonableness. Although the opinion of the Court below does not mention these decisions (although all were called to its attention) it necessarily rejected some, if not all of them. Because if the Court had been of opinion that Petitioner's proof removed the procedural presumption that the Commissioner is correct; if it had been of opinion that proof of regular course of business is *prima facie* proof of reasonableness (at least in the absence of inherent suspicious circumstances, of which it found none, *supra,* p. 14), then it would have been compelled to decide that there was *no* issue of fact, because respondent had offered nothing to create it.

Thus there is conflict among the circuits as to the character of proof required to sustain the taxpayer's contention, conflict in a matter which has constantly arisen and will continue to arise in the Board of Tax Appeals and which ought to be settled by decision of this Court.

Dated, August 19, 1940.

Respectfully submitted,

OTHO S. BOWLING,
Attorney for Petitioner.

The Heale Press : : New York City

Office - Supreme Court,
FILED
AUG 22 1940
CHARLES ELMORE CRO
CLE

No. 361 ✓

Supreme Court of the United States

OCTOBER TERM, 1940.

LONG ISLAND DRUG COMPANY, INC.,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI.

OTHO S. BOWLING,
Counsel for Petitioner.

INDEX

	PAGE
Two Cases on a Single Record	1
History of the Case	2
Jurisdiction	2
Questions Relied On	2

AUTHORITIES

Lunsford v. Commissioner of Internal Revenue, 62 Fed. (2d) 740	4
Manchester Board & Paper Co., Inc. v. Commissioner of Internal Revenue, 89 Fed. (2d) 315	3
Ox Fibre Brush Co. v. Blair, 32 Fed. (2d) 42	3
United States v. Seminole Nation, 290 U. S. 417	2
28 U. S. C. A., Sec. 347	2
28 U. S. C. A., Sec. 350	2

Supreme Court of the United States

OCTOBER TERM, 1940.

LONG ISLAND DRUG COMPANY, INC.,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

To the Honorable, the Chief Justice, and the Associate Justices of the Supreme Court of the United States:

This the petition of Long Island Drug Company, Inc., a domestic corporation organized under the laws of the State of New York, with its principal office at Jamaica, New York City, respectfully shows:

1. This is a petition for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Two Cases on a Single Record.

2. *There are two cases tried and determined on a single record. The cases involved Petitioner's income tax returns for the years 1931 and 1932-1933. This petition is filed in the case concerning the 1932-1933 tax* (B. T. A. Docket No. 79616). *A companion petition is being filed in the case concerning the 1931 tax* (B. T. A. Docket No. 75225).

History of the Case.

3. Petitioner filed its petitions with the Board of Tax Appeals to redetermine deficiencies assessed against it by the Commissioner of Internal Revenue for income taxes for the years 1932-1933 (Petition 1932-1933; R. 14-25). This, together with the petition concerning the return for the year 1931 (R. 5-12), was heard at a consolidated hearing. The Board handed down decisions determining that there were deficiencies as found by the Commissioner (R. 37, 38). The opinion of the Board is reported in 35 B. T. A. 328. Thereupon Petitioner filed petitions for review by the United States Circuit Court of Appeals for the Second Circuit (Petition 1932-1933; R. 44-49). That court affirmed the determination of the Board (R. 139). The opinion of that court is reported in 111 Fed. (2d) 593. The opinion of the Circuit Court was handed down May 6, 1940. Its order is dated May 23, 1940. On May 21, 1940, within the time allowed by the rules of that court, Petitioner filed its petition for rehearing. On May 23, 1940, said court handed down its order denying the petition.

Jurisdiction.

4. The Supreme Court has jurisdiction because this is a petition to review a United States Circuit Court of Appeals (Act of Feb. 13, 1925, 28 USCA §347). The petition for certiorari is filed within three months after the denial of the petition for a rehearing (28 USCA §350; *United States* v. *Seminole Nation,* 290 U. S. 417, 421).

The Questions Relied On.

5. The case arose because Petitioner in its income tax returns for the years in question claimed, as deductions from gross income, the salaries paid four officers. These

salaries were based upon fixed amounts, plus percentages of profits. Petitioner, before the Board of Tax Appeals, offered proof that the salaries paid, including percentages of profits, were reasonable. The Commissioner offered no proof. The Board of Tax Appeals, after reviewing Petitioner's proof, rejected it as insufficient on the ground that Petitioner had

> "* * * failed to sustain the burden of proof to show that respondent's determination was erroneous" (R. bottom p. 35).

These questions then arise:

A. When the taxpayer shows that the salaries of executives were arrived at in regular course of administration of the business, coupled with proof of the volume of business done and the duties performed, does not a presumption arise that the salaries so paid were reasonable, requiring some contrary evidence before the taxpayer's proof may be disregarded? The Circuit Court of Appeals for the Fourth Circuit so held (*Ox Fibre Brush Co.* v. *Blair,* 32 Fed. [2d] 42, 45), a decision which cannot be reconciled with this decision of the Circuit Court of Appeals for the Second Circuit.

This is a question of great general importance in the administration of the revenue laws. If the Board of Tax Appeals can ignore *all* the evidence of reasonableness, as it did here; if the Collector can slash salaries as he pleases without advancing any reason therefor; if his arbitrary judgment may be substituted for that of the managers of the business whose good faith is not attacked, then the taxpayer has no real remedy for capricious administrative action.

B. Is not the presumption that the determination of the Collector of Internal Revenue was correct, so as to require the taxpayer to produce some evidence to the contrary, a mere *procedural* presumption, which disappears when evidence is produced? The Circuit Court of Appeals for the Third Circuit (*Manchester Board & Paper Co., Inc.* v. *Commissioner of Internal Revenue,* 89 Fed. [2d] 315, 317) and

for the Sixth Circuit (*Lunsford* v. *Commissioner of Internal Revenue,* 62 Fed. [2d] 740, 742) have so held. The Board of Tax Appeals apparently held the contrary because it based its decision on the theory that Petitioner had "failed to sustain *the burden* of proof *to show* that *respondent's determination* was erroneous" (our italics, R. 35), that is to say, it assumed that the presumption could be put in the scales against Petitioner's proof. If it had weighed respondent's proof it would have been compelled to make a finding as to reasonableness, which it did not do. True, the Circuit Court of Appeals interpreted what the Board said as "the equivalent of a specific finding that the compensation paid, over and above the amount allowed by the Commissioner as deductible, was unreasonably high" (R. 129), but we consider this interpretation erroneous, and it is contrary to the one advanced by the Assistant Attorney General in his brief. The Circuit Court of Appeals did not expressly disapprove of the cited decisions in the Third, Fourth and Sixth Circuits, but the result reached cannot be reconciled with them.

This also is a question of great general importance, a corollary to the question first defined, because if the presumption is merely procedural, then the Board of Tax Appeals must weigh Petitioner's uncontradicted proof, and not base a decision, as it did here, on the theory that a non-existent presumption of substance outweighed it. The Supreme Court, so far as our research reveals, has never passed on this point, and it is important to the administration of the revenue laws that it should.

6. Because the Circuit Court of Appeals for the Second Circuit erred in deciding the foregoing questions, because its decisions cannot be reconciled with the cited decisions of other circuits, and because the questions are of general importance, all of which matters are more fully expounded in the brief accompanying the petition in the companion case (B. T. A. No. 75225), Petitioner prays that a writ of certiorari issue to the United States Circuit Court of Appeals

for the Second Circuit, to the end that its errors, if such they be, may be corrected.

Dated, August 20, 1940.

Respectfully submitted,

OTHO S. BOWLING,
Counsel for Petitioner.

I certify that, in my opinion, the foregoing petition is well founded and that it is not interposed for the purpose of delay.

OTHO S. BOWLING,
Counsel for Petitioner.

Office - Supreme Court, U. S.
FILED
SEP 17 1940
CHARLES ELMORE CROPLEY
CLERK

Nos. 360, 361

In the Supreme Court of the United States

OCTOBER TERM, 1940

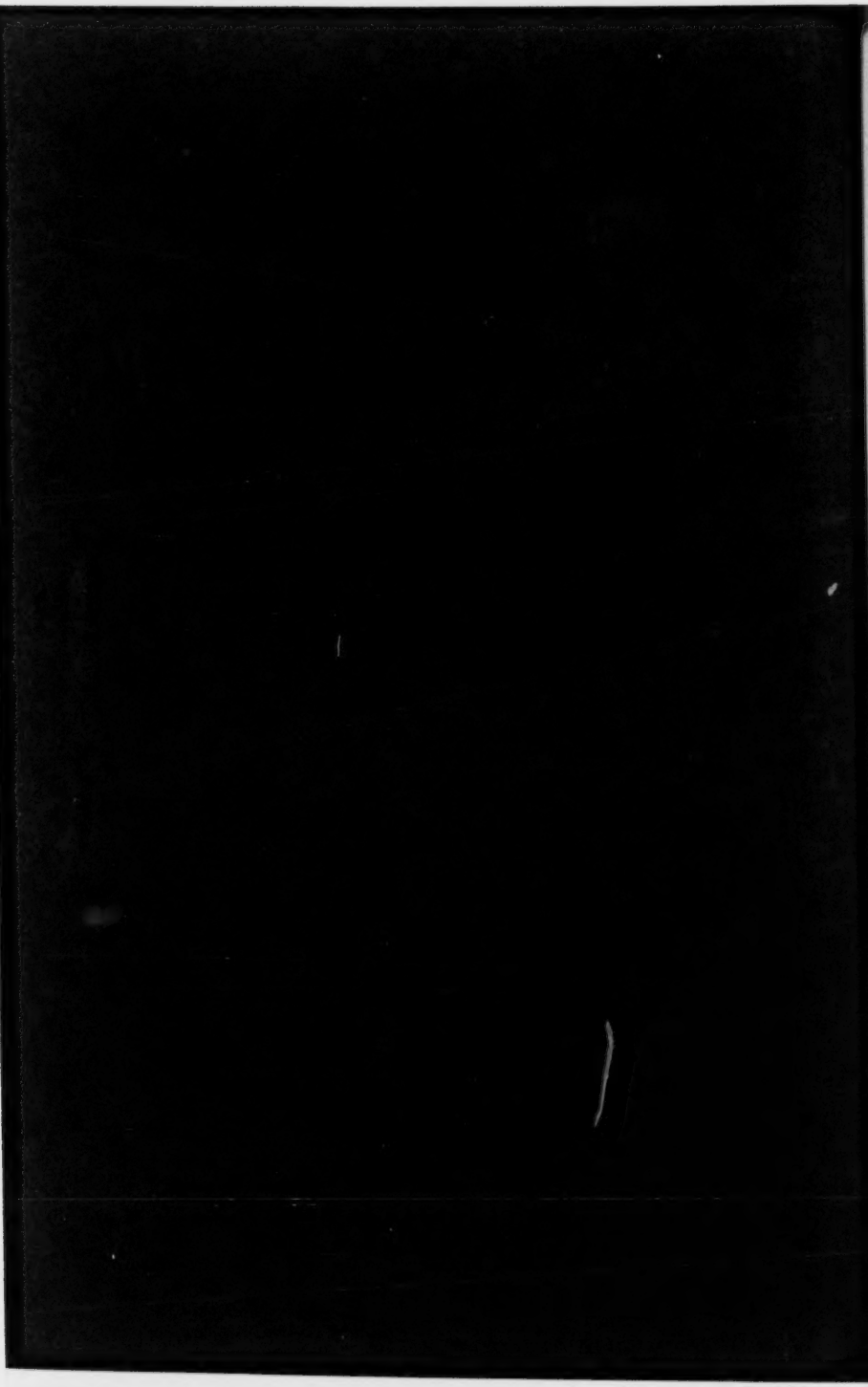
LONG ISLAND DRUG COMPANY, INC., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION



INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Argument	5
Conclusion	7
Appendix	8

CITATIONS

Cases:	
Ox Fibre Brush Co. v. *Blair*, 32 F. (2d) 42 affirmed 281 U. S. 115	6
Statutes:	
Revenue Act of 1928, c. 852, 45 Stat. 791, sec. 23	8
Revenue Act of 1932, c. 209, 47 Stat. 169, sec. 23	8
Miscellaneous:	
Treasury Regulations 74 promulgated under the Revenue Act of 1928:	
Art. 121	8
Art. 126	9
Treasury Regulations 77 promulgated under the Revenue Act of 1932:	
Art. 121	10
Art. 126	10

260046—40

In the Supreme Court of the United States

OCTOBER TERM, 1940

Nos. 360, 361

LONG ISLAND DRUG COMPANY, INC., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 27–36) is reported in 35 B. T. A. 328. The opinion of the Circuit Court of Appeals (R. 126–128) is reported in 111 F. (2d) 593.

JURISDICTION

The judgments [1] of the Circuit Court of Appeals were entered May 23, 1940 (R. 132–133). The pe-

[1] Both cases involved the same question and were consolidated for hearing and opinion before the Board (R. 27). They were disposed of in a single opinion by the court below (R. 126–128) but with separate judgments (R. 132, 133).

titions for writs of certiorari were filed August 22, 1940. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The question is whether the deduction from gross income given to a corporate taxpayer as "a reasonable allowance for salaries or other compensation for personal services actually rendered" should be increased to the extent of a portion of the compensation paid to its officers but disallowed by the Commissioner.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra*, pp. 8–10.

STATEMENT

The facts, as found by the Board of Tax Appeals (R. 27–36), may be summarized as follows:

The taxpayer is a corporation, organized in 1917 under the laws of the State of New York, and has its place of business in Jamaica, Long Island. It is engaged in the distribution at wholesale of drugs manufactured by others (R. 28).

The authorized capital of the corporation was $10,000 (100 shares of $100 par value). It issued only 30 shares of stock, which were held equally by the brothers Hyman and Maurice Alkon, and Bernard H. Mindling. In 1921, each of the stock-

holders sold one-half of his stock to Benedict Maisel, the nominee of the Reliance Distributing Company, a total of 15 shares for approximately $39,000. The stock of this corporation was owned by the parents of Charles J. Steinberg. In 1926 or 1927, the Reliance Distributing Company was dissolved and the 15 shares of stock were transferred to the Cunard Mercantile Corporation, the stock of which was also owned by the parents of Steinberg. Charles J. Steinberg was not a stockholder of the taxpayer corporation, nor did he have any equitable interest in the stock (R. 28).

Prior to 1930, the taxpayer had not paid any dividends. The Steinberg family, who controlled a half interest in the taxpayer corporation, having failed to receive any return on their investment, desired that it extend its business operations by putting out a new line of goods and opening a new market in Brooklyn. They also wanted the taxpayer corporation to employ Charles J. Steinberg (R. 28).

The stockholders were unable to agree upon the future conduct of the business of the corporation and the Steinbergs, through their nominee, brought suit to dissolve the corporation. The suit was dismissed upon the condition that the corporation was to extend its market into Brooklyn, promote a new line of goods under its own brand, and employ Charles J. Steinberg to be in charge of the new line. The annual compensation of the officers of

the corporation, including Steinberg, was to be at fixed annual rates plus equal shares in 50% of net profits. The corporation carried out the terms of this understanding. The bylaws of the corporation were amended March 11, 1931, to provide for the annual compensation of officers as follows: President, $13,500; treasurer, secretary, and assistant secretary, $12,500 each. In addition to the annual salary, each of these officers was to receive 12½% of the net profits of the corporation after subtracting from net profits the total due on state and federal taxes (R. 28–29).

During the taxable years, the officers of the corporation were: President, Hyman Alkon; treasurer, Maurice Alkon; secretary, Bernard Mindling; assistant secretary, Charles J. Steinberg (R. 29).

Although the corporation handled more units of sales in 1932 and in 1933 than in 1931, its earnings were less because prices had fallen, due to the depression (R. 31).

In its returns for the years 1931, 1932 and 1933, the taxpayer deducted the amounts of $83,000, $61,000 and $61,000, respectively, as compensation of its officers. In determining the deficiencies for the years 1931, 1932, and 1933, the Commissioner disallowed the amounts of $32,000, $10,000 and $10,000, respectively, which represented 50% of the net income of the corporation paid as additional salaries. The Commissioner determined that the deductions for additional salaries represented a dis-

tribution of profits and not compensation for the value of services rendered and that the fixed annual salaries allowed represented reasonable compensation for services rendered (R. 11, 22, 30).

The Board of Tax Appeals, after weighing the evidence, including the total compensation paid each officer, comprising both salary and fixed percentage of net earnings, found that the proof was unsatisfactory and did not show that the amounts paid were reasonable and not more than reasonable (R. 35). The Board concluded that the taxpayer had failed to sustain the burden of proof to show that the Commissioner's determination was erroneous with respect to reasonable compensation and held that the amounts paid out of net earnings were not deductible as ordinary and necessary business expenses (R. 35).

On appeal, the Circuit Court of Appeals held that the Board had found the compensation paid, over and above the amount allowed by the Commissioner as deductible, was more than reasonable and affirmed the Board (R. 127–128).

ARGUMENT

1. Petitioner's contention (Pet. 4) that the case has been decided upon a mistaken view of the weight to be given to the Commissioner's determination has no support in the record. The Circuit Court of Appeals concluded (R. 128) that the Board had made "the equivalent of a specific find-

ing * * * that the compensation paid, over and above the amount allowed by the commissioner as deductible, was unreasonably high." Under this view of the Board's findings, which we submit is the correct one (see R. 34, 35), there was no occasion to decide the issue upon which petitioner relies.

Petitioner, quite naturally, urges (Pet. 4) that the Circuit Court of Appeals misinterpreted the action of the Board. But whether or not it did so, in this particular case, raises no question calling for review in this Court.

2. Petitioner also claims (Pet. 3) a conflict with *Ox Fibre Brush Co.* v. *Blair,* 32 F. (2d) 42 (C. C. A. 4th), affirmed on another ground, 281 U. S. 115. That case merely holds that, while the burden of proof is on the taxpayer, the action of its board of directors in voting salaries is entitled to a *prima facie,* not a conclusive, presumption of reasonableness. In the particular circumstances, the Fourth Circuit there held that the taxpayer had sustained the burden of proof. Here, after reviewing all the evidence, the Board reached a different conclusion and the Circuit Court of Appeals held that it was supportable. Petitioner's real objection is that the evidence before the Board was sufficient to compel a finding that the salaries paid to its officers were reasonable. That scarcely raises a question calling for further review.

CONCLUSION

The decision of the court below is correct. There is no conflict of decisions and no question of general importance is presented. The petitions for writs of certiorari should, therefore, be denied.

Respectfully submitted.

FRANCIS BIDDLE,
Solicitor General.

SAMUEL O. CLARK, JR.,
Assistant Attorney General.

J. LOUIS MONARCH,
JOHN A. GAGE,
Special Assistants to the Attorney General.

EDWIN E. HUDDLESON, JR.,
Attorney.

SEPTEMBER, 1940.

APPENDIX

APPENDIX

Statutes and Regulations Involved

Revenue Act of 1928, c. 852, 45 Stat. 791:

> Sec. 23. Deductions from gross income.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> * * * * *

Section 23 (a) of the Revenue Act of 1932, c. 209, 47 Stat. 169, is the same as Section 23 (a) of the Revenue Act of 1928, *supra*.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

> Art. 121. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, * * *.

ART. 126. *Compensation for personal services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility.

While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable in all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

Articles 121 and 126 of Treasury Regulations 77, promulgated under the Revenue Act of 1932, are the same as Articles 121 and 126 of Treasury Regulations 74, *supra*.

U. S. GOVERNMENT PRINTING OFFICE: 1940